Internal Revenue Service

memorandum

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CORP:JMSchwartzman

date: NOV 6 1991

to: District Counsel, Jacksonville CC:JAX
Attn: Steve R. Johnson

from: Assistant Chief Counsel (Field Service) CC:FS

subject: [redacted] Pre-Acquisition Losses

This memorandum responds to your August 30, 1991, request for our views as to whether I.R.C. § 269, the *Libson Shops* doctrine or any other statutory or judicial theory applies to prevent the taxpayer's use of approximately $[redacted] of pre-acquisition losses of [redacted] to offset income generated by other corporations on taxpayer's final consolidated return for the period ending [redacted].

ISSUE

Whether post-merger income can be used to offset pre-merger, pre-acquisition losses, where two profit corporations are merged into a loss corporation belonging to the same consolidated group and the losses are incurred before the loss corporation became a member of the consolidated group.

FACTS

[redacted] ([redacted]) was the common parent of an affiliated group of corporations filing returns on a consolidated basis. In [redacted], [redacted] purchased [redacted] ([redacted]) by merging it into a subsidiary formed for that purpose. In this merger, the shareholders of [redacted] received [redacted] stock in exchange for their [redacted] stock.

At the time of its purchase by [redacted], [redacted] had substantial net operating losses. Because it continued to incur losses after its purchase by [redacted], these pre-acquisition losses could not be used and, thus, were carried forward. The losses incurred by [redacted] as a member of the [redacted] consolidated group were used to offset income generated by other members of that group.

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In [redacted], [redacted] sold substantially all of the operating assets of [redacted] to an unrelated party. [redacted] retained more than $[redacted] in accounts receivable until [redacted] and continued to make payments on several unfavorable leases until [redacted].

In [redacted], [redacted] merged two members of its consolidated group, [redacted] and [redacted],[1] into [redacted] in a statutory merger pursuant to section 368(a)(1)(A).

On [redacted], [redacted] was acquired by its management and some outside investors in a leveraged buyout. As a result, [redacted] filed a final consolidated return for its group for the period ending [redacted]. On that return, [redacted]'s pre-acquisition losses of approximately $[redacted] were used to offset the income of the two companies that had been merged into it.

DISCUSSION

Libson Shops Doctrine

In *Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957), 16 corporations, all owned by the same individuals in the same proportion, merged into one, new corporation. The surviving corporation carried forward and offset its income with the net operating losses of three of the 16 corporations which had losses and which continued to have losses. The Supreme Court, deciding the case under the 1939 Code, held that the surviving corporation was not entitled to offset its income with the carried forward net operating losses of the loss corporations because the income to be offset was not produced by substantially the same business which incurred the losses. That is, there was no continuity of the business enterprise that incurred the losses and such losses are only deductible against income subsequently produced by that business enterprise.

In the 1954 Code, Congress deleted the words "the taxpayer" from section 172 (section 122 of the '39 Code) and added section 381 to permit the carryover of certain attributes, including losses, in corporate reorganizations. Congress also added section 382 to prevent taxpayers from trafficking in losses. Under the '54 Code, the taxpayer in *Libson Shops* would have been entitled to offset the losses under section 381.

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[1] These two companies had been subsidiaries of [redacted], which was a subsidiary of [redacted]. Prior to the merger of these companies into [redacted], [redacted] was liquidated into [redacted].

In subsequent cases, the courts applied the continuity of business enterprise test to allow net operating losses to offset subsequently earned income only from the same business enterprise. *See, e.g., Kolker Brothers, Inc. v. Commissioner*, 35 T.C. 299 (1960), *non acq*. 1963-2 C.B. 6; *Irving-Kolmar Corp. v. Commissioner*, 35 T.C. 712 (1961). This doctrine was expanded to include a continuity of ownership factor as well. *Commissioner v. Virginia Metal Products, Inc.*, 290 F.2d 675 (3d Cir. 1961); *Norden-Ketay Corp. v. Commissioner*, 319 F.2d 902 (2d Cir. 1963), *cert. denied*, 379 U.S. 953.

In *Virginia Metal*, a corporation engaged in making aluminum doors and windows, as well as selling and servicing automatic furnace stokers, sustained losses in 1950 and 1951. Another corporation purchased all the shares of this corporation and proceeded to sell off all the assets, retaining only the corporate shell. A new business, formerly operated by the purchaser, was placed into the former corporation's corporate shell and proceeded to make money. The court concluded that the new venture was not entitled to offset its income against the losses of the old corporation, citing *Libson Shops*. The court reasoned that not only was there no continuity of business enterprise as in *Libson Shops*, but that there was also no continuity of ownership.

In 1965, however, the Ninth Circuit Court of Appeals squarely held that the *Libson Shops* doctrine is not applicable to cases arising under the '54 Code. *Maxwell Hardware Co. v. Commissioner*, 343 F.2d 713 (9th Cir. 1965). In *Maxwell Hardware*, an unsuccessful hardware store attracted two new investors who purchased a new issue of nonvoting preferred stock. The proceeds from the issuance of the nonvoting preferred stock was used to purchase real estate from the new investors. These new investors then managed a real estate division of the corporation, which was successful. The corporation deducted the net operating losses sustained by the hardware business against the profits of the real estate business. The Ninth Circuit, in reversing the Tax Court which had applied the *Libson Shops* doctrine, pointed out that revised section 172 and new sections 381 and 382 were intended to replace the uncertainties under the '39 Code and the case law thereunder. The Sixth Circuit soon followed suit in declaring that this doctrine did not apply under the '54 Code. *Frederick Steel Co. v. Commissioner*, 375 F.2d 351 (6th Cir. 1967), *cert. denied*, 389 U.S. 901 (1967).

The Service stated its position concerning the continued vitality of the *Libson Shops* doctrine under the '54 Code in Rev. Rul. 58-603, 1958-2 C.B. 147 and Rev. Rul. 63-40, 1963-1 C.B. 46. In Rev. Rul. 63-40, a corporation engaged in the manufacture and sale of light steel household products sustained losses. The corporation purchased the assets of another corporation and commenced the operation of drive-in restaurants. The corporation discontinued the household products business and sold the assets associated with that business, but retained essentially the same stockholders. The Service stated that it will not rely on *Libson Shops* to deny the carry forward of net operating losses when there is only minor or no change in stock ownership. When there is more than a minor change in stock ownership, however, the Service will continue to challenge the carry forward of losses of the old entity to offset income of the new entity.

In TIR-773[2], the Service modified Rev. Rul. 63-40. It announced that it would not follow the holding in *Maxwell Hardware* and stated that it will rely on *Libson Shops* under the '54 Code if there has been at least a 50 percent change in the beneficial ownership of the loss carryover and there has been a change in business as defined in section 382(a) and the regulations thereunder. The Service further stated that it will not apply the *Libson Shops* doctrine to a merger or any other transaction described in section 381(a) of the '54 Code. Rev. Rul. 58-603, 1958-2 C.B. 147. The Service noted that it will continue to rely on sections 269, 382 and 482 in appropriate circumstances.

On our facts, it may be argued that there has been more than a 50 percent change in the beneficial ownership of [redacted]'s losses. That argument is premised on the fact that the shareholders of [redacted] stock during the period when it incurred the $[redacted] losses at issue, held only a nominal proportion of [redacted] stock at the time the losses were offset by the income of the two profit corporations merged into [redacted]. Thus, the beneficial ownership of the losses changed from [redacted] percent by the old [redacted] shareholders, to primarily ownership by [redacted] and the [redacted] shareholders, only a small percentage of which were shareholders of old [redacted].

An alternative argument can be made to support the argument that there was at least a 50 percent change in the benefits of the loss carryover, based on the broad language of TIR-773. According to this alternative argument, since all or substantially all of the operating assets held by [redacted] during the period it incurred the losses at issue were sold, there was more than a 50 percent shift in the benefits of the loss.

In addition to this change in beneficial ownership of the losses at issue, there was a change in the business of [redacted], as defined in (old) section 382.[3]

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[2] Miscellaneous Announcement 653, *Mertens Law of Federal Income Taxation*, 1961-1965 Rulings.

[3] Old section 382(a)(1)(C) provided, "such corporation has not continued to carry on a trade or business substantially the same as that conducted before any change in the percentage

Specifically, the sale of televisions, video-cassette recorders, stereos and personal computers was discontinued altogether. Instead, [redacted]'s business became the operation of the two drug companies merged into it.

Since it appears that there has been more than a 50 percent change in the beneficial ownership of [redacted]'s loss carryover and it is clear that there was a substantial change in the business carried on by [redacted], *Libson Shops* may apply if the merger of the drug companies into [redacted] is not a transaction described in section 381(a). Rev. Rul. 58-603, 1958-2 C.B. 147.

Section 381(a) applies to liquidations pursuant section 332 and to *A*, *C*, *D*, *F* and *G* reorganizations to which section 361 applies. In our case, the merger of the two drug companies into [redacted] was pursuant to a state merger, an *A* reorganization. In your assistance request, however, you indicate that the transaction may not qualify as a valid *A* reorganization. Specifically, you indicate that the merger may have been entered into solely or primarily for the purpose of taking advantage of [redacted]'s net operating losses. As such, the merger may not qualify as a valid *A* reorganization because it lacked a business purpose, as required by the regulations. *See* Treas. Reg. §§ 1.368-1(b), 1.368-1(c) and 1.368-2(g).

The Service faces great litigation hazards in raising the lack of business purpose in connection with this purported "A" reorganization. *Laure v. Commissioner*, 653 F.2d 253 (6th Cir. 1981), *rev'g* 70 T.C. 1087; *American Bronze Corp. v. Commissioner*, 64 T.C. 1111 (1975). In *American Bronze*, the Tax Court held that there was a business purpose where a corporation merged with a competitor, based on the reduction of what would otherwise be duplicated accounting, administrative and operating expenses. In *Laure*, the Tax Court held that there was no business purpose where two companies operating different businesses were merged. The Sixth Circuit reversed on the basis that one corporation depended on the other for air services, which made it reasonable for the two to merge for business purposes.

While our case is distinguishable in that [redacted]s business was in no way related to the business of the [redacted] companies and one did not depend on the other for any services or goods, we do not believe that the courts will be receptive to the Service raising a business purpose argument to deny tax-free reorganization treatment to this transaction. In addition, we are concerned that

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ownership of the fair market value of such stock." This section 382 is applicable to the merger at issue in this case because the Tax Reform Act of 1986 (P.L. 99-514), as amended by P.L. 100-647, applies to ownership changes after December 31, 1986. Tax Reform Act Section 621(f)(1)(A)(i).

reorganization treatment to this transaction. In addition, we are concerned that this argument is a doubled-edged sword. Particularly, if the Service prevails on this issue, taxpayers may avail themselves of this precedent to argue that their transaction did not satisfy the requirements of a tax-free reorganization for lack of a business purpose, when it is to their advantage to do so.

As noted above, the applicability of the *Libson Shops* doctrine to cases arising under the '54 Code has been questionable since the Ninth Circuit's decision in *Maxwell Hardware Co. v. Commissioner*, 343 F.2d 713 (9th Cir. 1965). In *Maxwell Hardware*, the court stated that the Libson Shops doctrine is not controlling under the '54 Code.[4]

Despite the holding in *Maxwell Hardware*, the Fifth Circuit has continued to apply the doctrine to cases arising under the '54 Code. *See Home Construction Corporation of America v. United States*, 439 F.2d 1165 (5th Cir. 1971); *United States v. Jackson Oldsmobile*, 371 F.2d 808 (5th Cir. 1967). It is worth noting that, while both these cases were decided by the Fifth Circuit Court of Appeals, *Home Construction* was on appeal from the Southern District of Alabama and *Jackson Oldsmobile* was on appeal from the Middle District of Georgia. Both those courts are situated in what is now the Eleventh Circuit, as is the case before us, [redacted].

As recently as 1989, the Tax Court has intimated that the *Libson Shops* doctrine has continued vitality under the '54 Code. *Baicker v. Commissioner*, 93 T.C. 316 (1989). In *Baicker*, the court held that the *Libson Shops* doctrine does not establish, as petitioner contended, the right to carry over an investment tax credit under the '54 Code where there is continuity of the same business after a tax-free divisive reorganization. *Baicker*, 93 T.C. at 329. The court intimated that *Libson Shops* may have continued vitality as a general tax principle. *Id.* ("In any event, even though [*Libson Shops*] may possibly be regarded as establishing some sort of general principle that precludes carryovers of deductions in the absence of continuity of business operations, it is hardly a provision of 'law' that *affirmatively* requires the carryover sought here by petitioners.") (emphasis in the original). *See also Briarcliff Candy Corporation v. Commissioner*, 54 T.C.Memo 667 (1987).

Accordingly, we recommend that you further investigate whether the merger of the two [redacted] corporations into [redacted] did or did not constitute a valid *A* reorganization. If your factual findings support the conclusion that the

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[4] We note that Congress expressly made *Libson Shops* inapplicable after the Tax Reform Act of 1986. Report of the Committee on Finance, H.R. 3838, 99th Cong., 2d Sess. 247 (May 29, 1986).

sole or primary purpose of this transaction was not a valid business purpose, it may not constitute a valid *A* reorganization, as you point out in your memorandum to us. If you determine that it did not constitute a valid *A* reorganization, we recommend that you deny the offset of [redacted]'s pre-merger, pre-acquisition losses against the income of the [redacted] corporations which were merged into it, based on the application of the *Libson Shops* doctrine.[5]

If the merger constituted a valid *A* reorganization, the Service's position is that the *Libson Shops* doctrine is inapplicable. In such a case, section 381 would allow the carryover of the net operating losses. In addition, if the merger constituted a valid *A* reorganization, section 382, as then in effect, would not prevent the carryover of [redacted]'s losses because there had not been the requisite change in ownership of the loss corporation.[6]

Section 269(a)(1)

Section 269 can be applied to disallow the deduction of net operating loss carryovers if control of a corporation is acquired for the principal purpose of avoiding or evading federal income tax. For section 269(a)(1) to apply, there must be 1) an acquisition of corporate control and 2) a principal motive of tax avoidance. In your memorandum to us, you contend that section 269(a)(1) should be construed broadly enough to encompass both stock acquisitions and asset acquisitions. While the specific language of that section does not

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[5] We emphasize that the Service faces an uphill battle in arguing that a transaction lacked the requisite business purpose. *See Gregory v. Helvering*, 293 U.S. 465 (1935); *Atlas Tool Co. v. Commissioner*, 614 F.2d 860 (3d Cir. 1980), *aff'g* 70 T.C. 86 (1978); *Wortham Machinery Co. v. United States*, 521 F.2d 160 (10th Cir. 1975); *Becker v. Commissioner*, 221 F.2d 252 (2d Cir. 1955) ("The important factor is that [the transferee] was created to carry on corporate business indefinitely, although with a different line of manufacture from that conducted by its predecessor. *Cf. Lewis v. Commissioner*, (C.A.1) 176 F.2d 646. In the instant case the reorganization was effected for a sound 'business purpose.'"). While the information you sent us notes a tax motivation, it is not a pervasive topic of that document and certainly would not suffice to rebut taxpayer's explanations of a business purpose.

[6] The legislative history of the 1976 amendments to section 382 provide that *Libson Shops* would have no application to years governed by those amendments. *See* S. Rep. 938, 94th Cong., 2d Sess. 206 (1976).

preclude such a construction, the Service's published position specifically states that section 269(a)(1), "pertains to the acquisition of control of a corporation and not the acquisition of assets." Rev. Rul. 66-214, 1966-2 C.B. 98. *See also* Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 16.21(3) (5th ed. 1987). Since the instant transaction involved the transfer of assets, as opposed to stock, section 269(a)(1) is inapplicable.[7] As you note in your memorandum to us, section 269(a)(2) is inapplicable because both corporations were under common control.

In light of the Service's published position with respect to the applicability of section 269(a)(1) to asset acquisitions, the Service cannot raise section 269 to disallow the offset of [redacted]'s net operating loss carryforwards to the income of the [redacted] companies merged into it.

Defacto Liquidation

For purposes of certain Code provisions, a corporation has been considered defacto liquidated even though it has not formally dissolved under state law. *See, e.g.*, *Wier Long Leaf Lumber Co. v. Commissioner*, 173 F.2d 549 (5th Cir. 1949) (corporation not permitted to carry back unused excess profits tax credits because it had defacto liquidated). The determination of whether a corporation has defacto liquidated is based on all the facts and circumstances. *Wier Long Leaf Lumber*, *supra*.

Historically, courts have refused to sustain the Service's determination that a defacto liquidation has occurred, thereby precluding the carryover or carryback of a corporation's losses, where the corporation retains significant assets. Thus, the Service has failed in its attempt to challenge taxpayers' claims that losses sustained on one side of an alleged defacto liquidation can be carried forward or back to offset income on the other side of the defacto liquidation. *Acampo Winery and Distilleries, Inc. v. Commissioner*, 7 T.C. 629, *acq.*, C.B. 1949-1, 1, *acq. withdrawn and nonacquiescence substituted on the defacto liquidation issue*, 1961-2 C.B. 6; *Jackson Oldsmobile, Inc. v. United States*, 237 F. Supp. 779 (M.D. Ga. 1964), *aff'd*, 371 F.2d 808 (5th Cir. 1967); *See also Anbaco-Emig Corp. v. Commissioner*, 49 T.C. 100 (1967), *acq.*, 1968-2 C.B. 1; *Joseph Weidenhoff, Inc. v. Commissioner*, 32 T.C. 1222 (1959), *acq.*, 1960-2 C.B. 7. *Cf. Wier Long Leaf Lumber Co. v. Commissioner*, 173 F.2d 549 (5th Cir. 1949) (corporation continued to exist solely to take advantage of losses and for no real business purpose); *Winter & Company, Inc. (Indiana) v. Commissioner*, 13 T.C. 108 (1949).

[7] This is so even if the transaction did not qualify as a valid A reorganization.

In Rev. Rul. 61-191, 1961-2 C.B. 251, the Service withdrew its acquiescence to the defacto liquidation issue in *Acampo* and substituted its nonacquiescence. In that ruling, the Service clarified its position that net operating losses sustained by a corporation subsequent to its defacto liquidation may not be carried back to prior taxable years. A defacto liquidation occurs when a corporation has disposed of all or most of its operating assets, terminated its business activities and become a mere shell, a corporation in name and semblance only, without real corporate substance, serving no real corporate purpose and having no valid or compelling reason for continuing its existence, even though not formally dissolved. *See* Rev. Rul. 60-50, 1960-1 C.B. 150 (immediate reactivation of a corporation in a different business whose stock was cancelled after selling its only operating asset, but which retained its corporate charter, has the effect of a partial (not complete) liquidation of the old corporation, so that section 337 did not apply).

In Rev. Rul. 76-525, 1976-2 C.B. 98, the Service stated, "[t]he retention by a subsidiary corporation of any property, no matter how small in amount, for the purpose of continuing the operation of its present business or for the purpose of engaging in a new business, will prevent the distribution of the property that is actually distributed to its parent from qualifying as a distribution in complete liquidation within the meaning of section 332 of the Internal Revenue Code of 1954." *See* Natbony, *Twice Burned or Twice Blessed - Double Deductions in the Affiliated Corporation Context*, 6 J. Corp. Tax. 3, 17 (1979) ("if (1) a corporation's activities are not directed toward eventual dissolution, (2) there is no present intention to cancel the shareholders' stock, and (3) the shareholders intend, within a reasonable time, to infuse new assets into the dormant shell, the Service would apparently agree that no liquidation has occurred.")

In O.M. 19538 (Jan. 18, 1982), the Service considered whether an argument could be made that a defacto liquidation occurred when a corporation distributed all but $500 of its assets, changed its name and then began operating a completely different type of business. The Service determined, based on the Service's published position on when a corporation is completely liquidated (Rev. Rul. 76-525, Rev. Rul. 60-50 and also on *Jackson Oldsmobile*), that the defacto liquidation argument could not be maintained on such facts.

On our facts, [redacted] retained more than $[redacted] worth of accounts receivable. In addition, it appears that [redacted] did not direct [redacted]'s activities toward eventual dissolution. Thus, based on the Service's published position on this issue, we cannot argue that [redacted] was defacto liquidated, thereby precluding the carry over of its pre-merger, pre-acquisition losses to offset the income of the [redacted] companies merged into it.

CONCLUSION

We conclude that neither section 269 nor the defacto liquidation doctrine apply to prevent the offset of [redacted]'s net operating losses with the income generated by the [redacted] companies merged into it. On the other hand, if you can factually support a determination that the merger did not constitute a valid *A* reorganization, the *Libson Shops* doctrine may apply to prevent such an offset. If the merger constitutes a valid *A* reorganization, the *Libson Shops* doctrine may not be raised, in accordance with published Service position.

We emphasize that there are great litigation hazards in attempting to invalidate the "A" reorganization for lack of a business purpose. Accordingly, we request that you write in for formal Field Service Advice when you have more facts pertinent to this issue. There are also significant litigation hazards to the Service raising the *Libson Shops* doctrine to a case under the '54 Code.

If you have any questions, please contact Jerry Schwartzman at FTS 566-3335.

We note that this memorandum is FOR COUNSEL USE ONLY.

DANIEL J. WILES

By: [signature]
ALFRED C. BISHOP, JR.
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